



[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9648]

RIN 1545-BK53

Dividend Equivalents from Sources within the United States

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations relating to certain dividend equivalents for purposes of section 871(m) of the Internal Revenue Code (Code). The regulations provide guidance to nonresident alien individuals and foreign corporations that hold specified notional principal contracts providing for payments that are contingent upon or determined by reference to U.S. source dividend payments and to withholding agents.

DATES: Effective Date: These regulations are effective on **[INSERT DATE THIS DOCUMENT IS PUBLISHED IN THE FEDERAL REGISTER]**.

Applicability Date: For dates of applicability, see §§1.863-7(a)(2), 1.871-15(o), 1.881-2(e), 1.892-3(c), 1.894-1(e), 1.1441-2(f), 1.1441-3(h)(2), 1.1441-4(g)(1), 1.1441-6(i)(1), 1.1441-7(a)(4) and (g), and 1.1461-1(c)(2)(iii).

FOR FURTHER INFORMATION CONTACT: D. Peter Merkel or Karen Walny at (202) 317-6938 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

## Background

Congress enacted section 871(m) (originally designated as section 871(l)) on March 18, 2010, in section 541 of the Hiring Incentives to Restore Employment Act (HIRE Act), Public Law 111-147 (124 Stat. 71).

Section 871(m) applies to any substitute dividend made pursuant to a securities lending or a sale-repurchase transaction (repo) that is contingent upon, or determined by reference to, the payment of a U.S. source dividend, any payment made pursuant to a notional principal contract (NPC) that is a specified notional principal contract (specified NPC) when the payment is contingent upon, or determined by reference to, the payment of a U.S. source dividend, and any other payment determined by the Secretary to be substantially similar (dividend equivalent). Section 871(m) treats a dividend equivalent as a dividend from sources within the United States for purposes of sections 871(a), 881, and 4948(a), and chapters 3 and 4 of subtitle A of the Code. Section 871(m) generally applies to any dividend equivalent payment made on or after September 14, 2010. With respect to payments made on or after September 14, 2010, and on or before March 18, 2012, section 871(m)(3)(A) provides a factor-based test for determining whether an NPC is a specified NPC. With respect to payments made after March 18, 2012, section 871(m)(3)(B) provides that any NPC is a specified NPC unless the Secretary determines that the contract is of a type which does not have the potential for tax avoidance.

On January 23, 2012, the **Federal Register** published temporary regulations (TD 9572) at 77 FR 3108 (2012 temporary regulations), and a notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing at

77 FR 3202 (2012 proposed regulations, and together with the 2012 temporary regulations, 2012 section 871(m) regulations) under section 871(m) of the Code. The 2012 section 871(m) regulations related to dividend equivalents from sources within the United States paid to nonresident alien individuals and foreign corporations.

Corrections to the 2012 temporary regulations were published on February 6, 2012, and March 8, 2012, in the **Federal Register** at 77 FR 5700 and 77 FR 13969, respectively.

A correcting amendment to the 2012 temporary regulations was also published on August 31, 2012, in the **Federal Register** at 77 FR 53141.

The Treasury Department and the IRS received written comments on the 2012 section 871(m) regulations, which are available at [www.regulations.gov](http://www.regulations.gov). A public hearing was held on April 27, 2012. The majority of the comments related to the 2012 proposed regulations. Comments received regarding the provisions being finalized in this document are described in the Explanation of Provisions part of the preamble. An explanation of the other comments on the 2012 section 871(m) regulations is provided in the withdrawal of notice of proposed rulemaking, notice of proposed rulemaking and notice of public hearing on this subject in the Proposed Rules Section in this issue of the **Federal Register**.

### **Explanation of Provisions**

Section 1.871-15(d)(1) of these final regulations adopts with minimal changes §1.871-16T(b) of the 2012 temporary regulations, which incorporates the definition of a specified NPC provided in section 871(m)(3)(A). The four-factor specified NPC definition provided in §1.871-16T(b) applies to payments made after March 18, 2012, and before January 1, 2014. These final regulations extend the applicability of the four-

factor definition to payments made before January 1, 2016. Proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the **Federal Register** (the 2013 proposed regulations) contain the proposed definition of a specified NPC for payments made on or after January 1, 2016. The 2013 proposed regulations replace the 2012 proposed regulations, which provided a seven-factor approach to defining a specified NPC. Comments indicated that financial services providers would have difficulty modifying their systems to implement the 2012 proposed regulations under the timeline provided in the 2012 proposed regulations. The Treasury Department and the IRS believe that an extension of the statutory definition of the term specified NPC is necessary because the 2013 proposed regulations adopt a different approach from the 2012 proposed regulations for determining whether an NPC is a specified NPC. In addition, this extension will allow the financial services industry adequate time to establish necessary systems and other operating procedures to comply with the rules described in the 2013 proposed regulations.

The 2012 temporary regulations amended several regulations to clarify the application of section 871(m). For example, the 2012 temporary regulations modified §1.863-7 to provide that the general source rule for NPCs did not apply to a dividend equivalent under section 871(m). The 2012 temporary regulations also provided that section 871(m) and §1.871-16T applied to dividend equivalents received by foreign corporations. These final regulations adopt those temporary rules without change.

These final regulations also amend certain regulations under section 1441 to require a withholding agent to withhold tax owed with respect to a dividend equivalent.

Generally, these amendments are consistent with the amendments made in the 2012 temporary regulations. In addition, these final regulations reinstate to §1.1441-7(a)(3) examples relating to the definition of a withholding agent, which were inadvertently deleted by the 2012 temporary regulations.

One comment suggested that the regulations clarify that financial intermediaries and custodians are not parties to a section 871(m) transaction and should not be withholding agents with respect to a dividend equivalent payment. The Treasury Department and the IRS disagree and believe that a financial intermediary or custodian that satisfies the definition of a withholding agent provided in §1.1441-7(a) should be considered a withholding agent for purposes of section 871(m).

Another comment stated that §1.1441-3T(i), which permitted a withholding agent to use the distributing corporation's estimates to determine the amount of a dividend equivalent, was unduly harsh because the withholding agent remained liable for tax, interest, and penalties when the actual dividend exceeded the estimate. Section 1.1441-3T(i) is withdrawn and is not adopted in these final regulations. The Treasury Department and the IRS believe that withholding agents should comply with §1.1441-3(d)(1) in the event that the amount of a dividend equivalent is uncertain.

Other comments relating to the withholding provisions described the difficulties that withholding agents would encounter when administering the 2012 proposed regulations. The Treasury Department and the IRS believe that withdrawing the 2012 proposed regulations and publishing the 2013 proposed regulations addresses these comments.

In addition, these regulations finalize portions of the 2012 proposed regulations relating to the treatment of dividend equivalent payments for purposes of sections 892 and 894. Comments to the 2012 proposed regulations generally supported the proposed regulations under sections 892 and 894. These portions of the proposed regulations are finalized without change.

The Treasury Department and the IRS will continue to closely scrutinize other transactions that are not covered by section 871(m) and that may be used to avoid U.S. taxation and U.S. withholding. In addition, the IRS may challenge the U.S. tax results claimed in connection with transactions that are designed to avoid the application of section 871(m) using all available statutory provisions and judicial doctrines (including the substance over form doctrine, the economic substance doctrine under section 7701(o), the step transaction doctrine, and tax ownership principles) as appropriate. For example, nothing in section 871(m) precludes the IRS from asserting that a contract labeled as an NPC is in fact an ownership interest in the equity referenced in the contract.

### **Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations will primarily affect multinational

financial institutions, which tend to be larger businesses, and foreign entities. Moreover the number of taxpayers affected and the average burden are minimal. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### **Drafting Information**

The principal authors of these regulations are D. Peter Merkel and Karen Walny of the Office of Associate Chief Counsel (International). Other personnel from the Treasury Department and the IRS also participated in their development.

### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

### **Adoption of Amendments to the Regulations**

Accordingly, 26 CFR part 1 is amended as follows:

#### **PART 1-- INCOME TAXES**

Paragraph 1. The authority citation for part 1 is amended by revising the entry for §1.863-7 and adding an entry for §1.871-15 to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

§1.863-7 also issued under 26 U.S.C. 863(a) and 871(m). \* \* \*

§1.871-15 also issued under 26 U.S.C. 871(m). \* \* \*

Par. 2. Section 1.863-7 is amended by:

1. Revising paragraph (a)(1).
2. In paragraph (a)(2), revising the heading and adding a sentence at the end.

The revisions and addition read as follows:

§1.863-7 Allocation of income attributable to certain notional principal contracts under section 863(a).

(a) Scope--(1) Introduction. This section provides rules relating to the source and, in certain cases, the character of notional principal contract income. However, this section does not apply to income from a section 988 transaction within the meaning of section 988 and the regulations thereunder, relating to the treatment of certain nonfunctional currency transactions. Further, this section does not apply to a dividend equivalent described in section 871(m) and the regulations thereunder. Notional principal contract income is income attributable to a notional principal contract as defined in §1.446-3(c). An agreement between a taxpayer and a qualified business unit (as defined in section 989(a)) of the taxpayer, or among qualified business units of the same taxpayer, is not a notional principal contract, because a taxpayer cannot enter into a contract with itself.

(2) Effective/applicability date. \* \* \* With respect to a dividend equivalent described in section 871(m) and the regulations thereunder, this section applies to payments made on or after January 23, 2012.

\* \* \* \* \*

**§1.863-7T [Removed].**

Par. 3. Section 1.863-7T is removed.

Par. 4. Section 1.871-15 is added as follows:

§1.871-15 Treatment of dividend equivalents.

(a) through (c) [Reserved].

(d) Specified NPCs--(1) Specified NPCs before January 1, 2016. For payments made after March 18, 2012, and before January 1, 2016, a specified NPC is any NPC if-

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(i) In connection with entering into the contract, any long party to the contract transfers the underlying security to any short party to the contract;

(ii) In connection with the termination of the contract, any short party to the contract transfers the underlying security to any long party to the contract;

(iii) The underlying security is not readily tradable on an established securities market; or

(iv) In connection with entering into the contract, the underlying security is posted as collateral by any short party to the contract with any long party to the contract.

(d)(2) through (n) [Reserved].

(o) Effective/applicability date. This section applies to payments made on or after January 23, 2012.

**§1.871-15T [Removed].**

Par. 5. Section 1.871-15T is removed.

**§1.871-16T [Removed].**

Par. 6. Section 1.871-16T is removed.

Par. 7. Section 1.881-2 is amended by:

1. Revising paragraph (b)(3).

2. In paragraph (e), revising the heading and adding a sentence at the end.

The revisions and addition read as follows:

§1.881-2 Taxation of foreign corporations not engaged in U.S. business.

\* \* \* \* \*

(b) \* \* \*

(3) Dividend Equivalents. For rules applicable to a foreign corporation's receipt of a dividend equivalent, see section 871(m) and the regulations thereunder.

\* \* \* \* \*

(e) Effective/applicability date. \* \* \* Paragraph (b)(3) of this section applies to payments made on or after January 23, 2012. \* \* \*

**§1.881-2T [Removed].**

Par. 8. Section 1.881-2T is removed.

Par. 9. Section 1.892-3 is added to read as follows:

**§1.892-3 Income of foreign governments.**

(a)(1) through (a)(5) [Reserved]. For further information, see §1.892-3T(a)(1) through (a)(5).

(6) Dividend equivalents. Income from investments in stocks includes the payment of a dividend equivalent described in section 871(m) and the regulations thereunder.

(b) [Reserved]. For further information, see §1.892-3T(b).

(c) Effective/applicability date. Paragraph (a)(6) of this section applies to payments made on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Par. 10. Section 1.894-1 is amended by:

1. Redesignating paragraph (c) as (c)(1) and adding paragraph (c)(2).
2. In paragraph (e):

- a. Revising the heading,
- b. Revising the third sentence, and
- c. Adding a new fourth sentence.

The addition and revisions read as follows:

§1.894-1 Income affected by treaty.

\* \* \* \* \*

(c) \* \* \*

(2) Dividend equivalents. The provisions of an income tax convention relating to dividends paid to or derived by a foreign person apply to the payment of a dividend equivalent described in section 871(m) and the regulations thereunder.

\* \* \* \* \*

(e) Effective/applicability date. \* \* \* Paragraph (c)(1) of this section applies to payments made after November 13, 1997. Paragraph (c)(2) of this section applies to payments made on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**. \* \* \*

Par. 11. Section 1.1441-2 is amended by:

1. Revising paragraph (b)(6).
2. Adding a sentence to the end of paragraph (f).

The revision and addition read as follows:

§1.1441-2 Amounts subject to withholding.

\* \* \* \* \*

(b) \* \* \*

(6) Dividend equivalents. Amounts subject to withholding include a dividend equivalent described in section 871(m) and the regulations thereunder. For this purpose, the amount of a dividend equivalent includes any gross amount that is used in computing any net amount that is transferred to or from the taxpayer under the terms of the transaction or any other payment described in section 871(m) and the regulations thereunder.

\* \* \* \* \*

(f) Effective/applicability date. \* \* \* Paragraph (b)(6) of this section applies to payments made on or after January 23, 2012.

**§1.1441-2T [Removed].**

Par. 12. Section 1.1441-2T is removed.

Par. 13. Section 1.1441-3 is amended by:

1. Revising paragraph (h).
2. Removing paragraph (i).
3. Redesignating paragraph (j) as newly-designated paragraph (i) and removing the language “paragraph (g)” from newly-redesignated paragraph (i) and adding “paragraphs (g) and (h)” in its place.

The revisions read as follows:

**§1.1441-3 Determination of amounts to be withheld.**

\* \* \* \* \*

(h) Dividend equivalents--(1) Withholding on gross amount. The gross amount of a dividend equivalent described in section 871(m) and the regulations thereunder is

subject to withholding in an amount equal to the gross amount of the dividend equivalent used in computing any net amount that is transferred to or from the taxpayer.

(2) Effective/applicability date. This paragraph (h) applies to payments made on or after January 23, 2012.

\* \* \* \* \*

**§1.1441-3T [Removed].**

Par. 14. Section 1.1441-3T is removed.

Par. 15. Section 1.1441-4 is amended by:

1. Revising paragraphs (a)(3)(i) and (iii).
2. Revising the heading to paragraph (g).
3. Removing the language “2000.” in paragraph (g)(1) and adding “2000, except that paragraph (a)(3)(iii) of this section applies to payments made on or after January 23, 2013.” in its place

The revisions read as follows:

**§1.1441-4 Exemptions from withholding for certain effectively connected income and other amounts.**

(a) \* \* \*

(3) Income on notional principal contracts--(i) General rule. Except as otherwise provided in paragraph (a)(3)(iii) of this section, a withholding agent that pays amounts attributable to a notional principal contract described in §1.863-7(a) or §1.988-2(e) shall have no obligation to withhold on the amounts paid under the terms of the notional principal contract regardless of whether a withholding certificate is provided. However, a withholding agent must file returns under §1.1461-1(b) and (c) reporting the income that it must treat as effectively connected with the conduct of a trade or business in the

United States under the provisions of this paragraph (a)(3). Except as otherwise provided in paragraph (a)(3)(ii) of this section, a withholding agent must treat the income as effectively connected with the conduct of a U.S. trade or business if the income is paid to, or to the account of, a qualified business unit of a foreign person located in the United States or, if the payment is paid to, or to the account of, a qualified business unit of a foreign person located outside the United States, the withholding agent knows, or has reason to know, the payment is effectively connected with the conduct of a trade or business within the United States. Income on a notional principal contract does not include the amount characterized as interest under the provisions of §1.446-3(g)(4).

\* \* \* \* \*

(iii) Exception for specified notional principal contracts. A withholding agent that makes a payment attributable to a specified notional principal contract described in section 871(m) and the regulations thereunder that is not treated as effectively connected with the conduct of a trade or business within the United States is obligated to withhold on the amount of the payment that is a dividend equivalent.

\* \* \* \* \*

(g) Effective/applicability date--\* \* \*

\* \* \* \* \*

#### **§1.1441-4T [Removed].**

Par. 16. Section 1.1441-4T is removed.

Par. 17. Section 1.1441-6 is amended by:

1. Revising paragraph (c)(2).

2. Redesignating paragraph (h) as paragraph (i) and revising newly-redesignated paragraph (i)(1).

3. Adding a new paragraph (h).

The revisions and addition read as follows:

§1.1441-6 Claim of reduced withholding under an income tax treaty.

\* \* \* \* \*

(c) \* \* \*

(2) Income to which special rules apply. The income to which paragraph (c)(1) of this section applies is dividends and interest from stocks and debt obligations that are actively traded, dividends from any redeemable security issued by an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1), dividends, interest, or royalties from units of beneficial interest in a unit investment trust that are (or were upon issuance) publicly offered and are registered with the Securities and Exchange Commission under the Securities Act of 1933 (15 U.S.C. 77a), and amounts paid with respect to loans of securities described in this paragraph (c)(2). With respect to a dividend equivalent described in section 871(m) and the regulations thereunder, this paragraph (c)(2) applies to the extent that the underlying security described in section 871(m) and the regulations thereunder satisfies the requirements of this paragraph (c)(2). For purposes of this paragraph (c)(2), a stock or debt obligation is actively traded if it is actively traded within the meaning of section 1092(d) and §1.1092(d)-1 when documentation is provided.

\* \* \* \* \*

(h) Dividend equivalents. The rate of withholding on a dividend equivalent may be reduced to the extent provided under an income tax treaty in effect between the United States and a foreign country. For this purpose, a dividend equivalent as described in section 871(m) and the regulations thereunder is treated as a dividend from sources within the United States. To receive a reduced rate of withholding with respect to a dividend equivalent, a foreign person must satisfy the other requirements described in this section.

(i) Effective/applicability dates--(1) General rule. This section applies to payments made after December 31, 2000, except that--

(i) Paragraph (g) of this section applies to payments made after December 31, 2001, and

(ii) Paragraph (h) of this section applies to payments made on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

\* \* \* \* \*

Par. 18. Section 1.1441-7 is amended by:

1. Removing paragraph (a)(3).
2. Redesignating paragraph (a)(2) as paragraph (a)(3) and revising newly-redesignated paragraph (a)(3).
3. Adding a new paragraph (a)(2).
4. Adding a new paragraph (a)(4).
5. Revising paragraph (g).

The revisions and additions read as follows:

§1.1441-7 General provisions relating to withholding agents.

(a) \* \* \*

(2) Withholding agent with respect to dividend equivalents. Each person that is a party to any contract or arrangement that provides for the payment of a dividend equivalent, as described in section 871(m) and the regulations thereunder, is treated as having control and custody of the payment.

(3) Examples. The following examples illustrate the rules of paragraphs (a)(1) and (a)(2) of this section:

Example 1. USB is a broker organized in the United States. USB pays U.S. source dividends and interest, which are amounts subject to withholding under § 1.1441-2(a), to FC, a foreign corporation that has an investment account with USB. USB is a withholding agent as defined in paragraph (a)(1) of this section.

Example 2. USB is a bank organized in the United States. FB is a bank organized in country X. FB has an omnibus account with USB through which FB invests in debt and equity instruments that pay amounts subject to withholding as defined in § 1.1441-2(a). FB is a nonqualified intermediary, as defined in § 1.1441-1(c)(14). Both USB and FB are withholding agents as defined in paragraph (a)(1) of this section.

Example 3. The facts are the same as in Example 2, except that FB is a qualified intermediary. Both USB and FB are withholding agents as defined in paragraph (a)(1) of this section.

Example 4. FB is a bank organized in country X. FB has a branch in the United States. FB's branch has customers that are foreign persons who receive amounts subject to withholding, as defined in § 1.1441-2(a). FB is a withholding agent under paragraph (a)(1) of this section and is required to withhold and report payments of amounts subject to withholding in accordance with chapter 3 of the Internal Revenue Code.

Example 5. X is a foreign corporation. X pays dividends to shareholders who are foreign persons. Under section 861(a)(2)(B), a portion of the dividends are from sources within the United States and constitute amounts subject to withholding within the meaning of § 1.1441-2(a). The dividends are not subject to tax under section 884(a). See section 884(e)(3). X is a withholding agent under paragraph (a)(1) of this section.

Example 6. FC, a foreign corporation, enters into a notional principal contract (NPC) with Bank X, a bank organized in the United States. The NPC is a specified NPC for purposes of section 871(m) and the regulations thereunder. FC is the long party to

the contract and Bank X is the short party. The NPC references a specified number of shares of dividend-paying common stock issued by a domestic corporation. As the long party, FC receives payments from Bank X based on any appreciation in the value of the common stock and dividends paid with respect to the common stock. As the short party, Bank X receives payment from FC based on any depreciation in the value of the common stock and a payment based on LIBOR. Bank X is a withholding agent because Bank X is deemed to have control and custody of a dividend equivalent as a party to the NPC. If FC's tax liability under section 881 has not been satisfied in full by Bank X as withholding agent, FC is required to file a return on Form 1120-F (U.S. Income Tax Return of a Foreign Corporation).

(4) Effective/applicability date. Paragraph (a)(2) of this section and Example 6 apply on or after January 23, 2012.

\* \* \* \* \*

(g) Effective/applicability date. Except as otherwise provided in paragraphs (a)(4) and (f)(3) of this section, this section applies to payments made after December 31, 2000.

**§1.1441-7T [Removed].**

Par. 19. Section 1.1441-7T is removed.

Par. 20. Section 1.1461-1 is amended by:

1. Revising paragraph (c)(2)(i)(L).
2. Adding paragraph (c)(2)(iii).

The revision and addition read as follows:

**§1.1461-1 Payment and returns of tax withheld.**

\* \* \* \* \*

(c) \* \* \*

(2) \* \* \*

(i) \* \* \*

(L) Dividend equivalents as described in section 871(m) and the regulations  
thereunder;

\* \* \* \* \*

(iii) Effective/applicability date. Paragraph (c)(2)(i)(L) of this section applies on or after January 23, 2012.

\* \* \* \* \*

**§1.1461-1T [Removed].**

Par. 21. Section 1.1461-1T is removed.

John Dalrymple  
Deputy Commissioner for Services and Enforcement.

Approved: November 26, 2013

Mark J. Mazur  
Assistant Secretary of the Treasury (Tax Policy).